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94-2030

IN THE

Supreme Court of the United States

OCTOBER TERM, 1994

MARK V. HARKINS, SULLIVAN & LONG, INC., JOSEPH D. LAPOTA, JR., SAMUEL HOOKER, CHARLES HAWKER, CAROLE BLAND, AUDREY HEWITT, ANTHONY HEWITT, JOHN ECKENSTEN, RONALD J. MORAN, LESLEY RANNEY MORAN, TIMOTHY J. MORAN, LEON D. ARDELEAN, JEFFREY J. SIMS, SHEFFIELD WOLK, A. J. BLYTHE, DOROTHY B. NUSSDORF, DAN CHLIPALA, and JAMES HAMBURGER,

Petitioners,

v.

SCATTERED CORPORATION,

Respondent.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

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PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Do the securities laws' prohibitions on market manipulation exempt deliberate manipulative acts which move a stock price towards a perceived "true economic value"?

2. Can a market maker who short sells vastly more shares of a company than actually exist, be considered an "issuer" subject to liability under § 12(1) of the Securities Act of 1933, 15 U.S.C. § 771(1), for selling securities without a registration statement, in violation of Securities Act § 5, 15 U.S.C. § 77e?

LIST OF PARTIES

The plaintiffs to the proceedings below, all of whom are petitioners here, were Mark V. Harkins, Sullivan & Long, Inc., Joseph D. LaPota, Jr., Samuel Hooker, Charles Hawker, Carole Bland, Audrey Hewitt, Anthony Hewitt, John Eckensten, Ronald J. Moran, Lesley Ranney Moran, Timothy J. Moran, Leon D. Ardelean, Jeffrey J. Sims, Sheffield Wolk, A.J. Blythe, Dorothy B. Nussdorf, Dan Chlipala, and James Hamburger, all individually and as representatives of the certified class. Scattered Corporation, defendant below, is the respondent before this Court.

No petitioner has any parent or subsidiary company.

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PETITION FOR A WRIT OF CERTIORARI

OPINIONS BELOW

Petitioners respectfully request that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Seventh Circuit.

The February 8, 1995 opinion of the Court of Appeals is reprinted in the Appendices ("Pet. App.") at 1a. The opinion is reported at 47 F.3d 857 (7th Cir. 1995). The Court of Appeals' March 13, 1995 Order denying rehearing and rehearing *en banc* is reprinted at Pet. App. 32a.

The January 10, 1994 Memorandum Opinion and Order of the District Court is reported at 844 F.Supp. 416 (N.D. Ill. 1994) and reprinted at Pet. App. 18a, and

the District Court's March 29, 1994 oral ruling is unreported and reprinted at Pet. App. 28a.

JURISDICTION

On February 8, 1995, the Seventh Circuit Court of Appeals entered a judgment and opinion affirming the case dismissal, and a timely petition for rehearing with suggestion for rehearing *en banc* was denied on March 13, 1995.

This Court's jurisdiction to review the judgment of the Court of Appeals is invoked pursuant to 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

This Petition involves the following United States statutes:

1. 15 U.S.C. § 77b(4)

   Definitions

   When used in this subchapter, unless the context otherwise requires . . . (4) The term "issuer" means every person who issues or proposes to issue any security . . .

2. 15 U.S.C. § 77d(1)

   Exempted transactions

   The provisions of section 77e shall not apply to—(1) transactions by any person other than an issuer, underwriter, or dealer.

3. 15 U.S.C. § 77e. *Prohibitions relating to interstate commerce and the mails*

   Sale or delivery after sale of unregistered securities

(a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or

(2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

Necessity of prospectus meeting requirements of section 77j of this title

(b) It shall be unlawful for any person, directly or indirectly—

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to carry or transmit any prospectus relating to any security with respect to which a registration statement has been filed under this subchapter, unless such prospectus meets the requirements of section 77j of this title; or

(2) to carry or cause to be carried through the mails or in interstate commerce any such security for the purpose of sale or for delivery after sale, unless accompanied or preceded by a prospectus that meets the requirements of subsection (a) of section 77j of this title.

Necessity of filing registration statement

(c) It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security, or while the registration statement is the subject of a refusal order or stop order or (prior to the effective date of the registration statement) any public proceeding or examination under section 77h of this title.

4. 15 U.S.C. § 77l(1)

Civil liabilities arising in connection with prospectuses and communications

Any person who—

(1) offers or sells a security in violation of Section 77e of this title . . . shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

5. 15 U.S.C. § 78i(a)(2)

Manipulation of security prices
Transactions relating to purchase or sale of security

(a) It shall be unlawful for any person, directly or indirectly, by the use of the mails or any means or instrumentality of interstate commerce, or of any facility of any national securities exchange, or for any member of a national securities exchange—

(2) To effect, alone or with one or more other persons, a series of transactions in any security registered on a national securities exchange creating actual or apparent active trading in such security or raising or depressing the price of such security, for the purpose of inducing the purchase or sale of such security by others.

STATEMENT OF THE CASE

Petitioners seek review of the Court of Appeals' decision affirming the dismissal of their consolidated class complaints alleging respondent's violations of the federal securities laws, *inter alia*, by short selling massive quantities of stock on trading tickets that were intentionally mismarked in order to conceal the true position and evade the applicable delivery requirements.

The District Court dismissed the complaint, *In re: Scattered Corporation Securities Litigation,* 844 F. Supp. 416 (N.D. Ill. 1994), in the view that respondent had injected accurate information into the marketplace and had done nothing wrong. Pet. App. 18a and 28a.

The Court of Appeals affirmed, *Sullivan & Long, Inc. v. Scattered Corp.,* 47 F.3d 857 (7th Cir. 1995), holding that movement of price towards a "true economic value" is not actionable market manipulation, and that a short seller market maker cannot be an issuer even if it short sells more than the total number of a corporation's outstanding shares. Pet. App. 1a.

A. Factual Background.

In early 1993, LTV Corporation, one of the country's largest steel makers, had been in bankruptcy for a number of years. At the time, LTV had 122 million issued and outstanding shares of common stock, which traded at about 62¢ a share. On February 26, 1993, LTV announced a plan of reorganization which, if approved, would convert all of its existing common shares into warrants to purchase new stock in the reorganized company, most of whose stock would be owned by former creditors. The reorganization plan estimated that the old stock would have an ultimate value of 3-4¢ a share.

Anticipating the bankruptcy court's May 27, 1993 approval of the reorganization plan, Scattered devised a short selling scheme of enormous size. Scattered saw the reorganization plan as an opportunity to wildly profit from manipulating the market for LTV stock by short-selling vast amounts of LTV shares in violation of applicable trading rules [1] and applicable five-day delivery obligations. Scattered's short-selling plan was done in a manner intended to cap the share price and maneuver it on a slow and steady decline, while delaying delivery of the shares, until the shares had been converted into the

[1] New York Stock Exchange Rule 440F; Chicago Stock Exchange Article VII, Rule 5, and Article VIII, Rules 1, 3 and 4.

nearly valueless warrants. Similar to the comedy movie "The Producers" [2], Scattered short-sold a huge number of LTV shares—far more than ever existed—mislabeled (on the trading tickets) as "short exempt".[3] By mismarking the trades "short-exempt", Scattered was able to evade its delivery obligations until the shares had been converted to warrants—long after the required trade settlement date. Deliberately mislabeling the trades as "short exempt" also furthered the scheme by avoiding the five-day delivery requirement and cleverly concealing Scattered's "short overhang" position from being publicly known and incorporated into the LTV shares' market price. This mislabeling was an integral part of the scheme, since public knowledge of a "short overhang" vastly exceeding the number of outstanding shares would have driven up the LTV share price and broken the scheme in its early stages.[4]

Scattered's scheme divorced the market from normal forces of supply and demand in two significant aspects. In addition to hiding the short position from detection,

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[2] In "The Producers", two schemers, has-been Broadway impresario Max Bialystock (played by Zero Mostel), and his quiet accountant Leo Bloom (played by Gene Wilder), raise money to produce a Broadway play by selling investors over 3000% shares of a play, and select and cast a play that would surely flop, intending to pocket the money raised from the investors, who will not look for their money back on a failure. The scheme unravels when the play, "Springtime for Hitler", becomes a hit farce, and the producers go to jail for their fraud.

[3] The "short-exempt" designation on a trading ticket means that the trade qualifies for an exemption from the usual five-day delivery requirements because the trade involves legitimate arbitrage or is necessary to maintain an orderly market. Scattered's LTV trades did not qualify for any such exemption. See Article VII, Rule 5 of the Chicago Stock Exchange.

[4] Because nonexempt short sales and short positions are routinely reported in the market, Scattered's short sales would have been reported, and its true massive short position disclosed and factored into the market price, if Scattered properly marked its tickets "short" rather than the misleading "short exempt" designation.

Scattered also timed its short selling to cap the LTV share price; that is, to prevent a rise which could have defeated the scheme. To maximize its profits from the scheme, Scattered also needed to keep the share price slowly and smoothly drifting continually lower, thereby producing higher revenues from the short sales.[5]

Scattered needed to cap prices to prevent any price upswing that would force it to "buy-in" (i.e., purchase replacement shares on the open market) the stock to cover any losses. Had Scattered *not* manipulated the market, and if it had to acquire shares for delivery within the prescribed five-day period,[6] the demand created by the purchases to cover the huge short positions would have naturally caused the share price to rise.

Such an upswing would have broken the scheme and financially ruined Scattered, which at the beginning of its scheme had insufficient capital to withstand any adverse price move.[7] In that event the Midwest Clearing Corporation—the stock clearing corporation of the Chicago Stock Exchange (formerly the Midwest Stock Exchange), where Scattered was a market maker and where many of the trades occurred—would have had to step in and guarantee Scattered's losses.[8] Scattered's short position eventually became so large that it exceeded the entire capacity of the Chicago Stock Exchange to cover the short position.

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[5] A sudden price drop would greatly diminish or end the revenue stream.

[6] Although not effective at the time, the recently announced "T+3" provisions would have required settlement within only three business days.

[7] With only approximately $1.5 million in capital in January 1993, Scattered would have been unable to meet its obligations to deliver the amount of LTV shares it sold short very early in the scam.

[8] Scattered actually put the liquidity of the Chicago Exchange and its clearing corporation at substantial risk. After Scattered

The scheme worked fabulously well for Scattered. The LTV stock's manipulated price crept gradually and steadily downward from just over 62¢ per share at the announcement of the reorganization plan to 7.8¢ per share on its last trade on June 29, 1993, the last day it traded. In total, Scattered's LTV trading produced it a profit of some $25 million.

B. The Litigation.

Several LTV stock purchasers[9] sued Scattered, alleging securities fraud, market manipulation, engaging in an offering of securities, in violation of the Securities Act of 1933 and the Securities Exchange Act of 1934, plus violation of the federal RICO statute, and state law securities fraud, consumer fraud, and unjust enrichment.[10]

The trial court certified a class but dismissed the plaintiffs' initial consolidated complaint—on a F.R.C.P. 12 (b)(6) motion without any evidentiary submissions—on the trial court's belief that Scattered's trading was not actionable and that Scattered had done nothing wrong but had merely profited from injecting accurate information into the marketplace. Pet. App. 18a. Although plaintiffs amended their complaint by adding additional facts about Scattered's scheme and its effect on the plaintiffs and the class, the trial court again dismissed their

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was told to produce shares to cover purchases, Scattered's attorney, in a June 23, 1993, letter, responded by rebuking the demand with the threat that a forced buy-in would cause an uncontrollable and devastating price rise, saying "the resulting liability would be immense and could conceivably threaten the liquidity of both the Midwest Clearing Corporation and the Exchange itself."

[9] Most of the petitioners are individual public investors, although petitioner Sullivan & Long, Inc. is itself a market maker adversely affected by Scattered's scheme.

[10] Plaintiffs also alleged that Scattered violated stock exchange rules regulating short sales, such as New York Stock Exchange Rule 440F ("short exempt" sales are excluded from reporting on Form SS20 and are included in total sales only).

claims on the same grounds, without receiving any evidence, Pet. App. 28a, and plaintiffs appealed.

The Seventh Circuit Court of Appeals affirmed the dismissal. *Sullivan & Long, Inc. v. Scattered Corporation*, 47 F.3d 857 (7th Cir. 1995). In doing so, the Court of Appeals found that Scattered's manipulation was not actionable because it was done to move the price of the old LTV shares towards their "true economic value" of 3-4¢. Additionally, the Appellate Court held that a single short seller market maker such as Scattered cannot be an "issuer" under the securities laws, regardless of how many shares it sells, even if that number far exceeds the total number of outstanding shares.

REASONS FOR GRANTING THE WRIT

I. THE SEVENTH CIRCUIT'S ADOPTION OF AN EXCEPTION FOR "GOOD" MANIPULATION HAS NO LEGAL BASIS, CONFLICTS WITH OTHER CIRCUITS' DECISIONS THAT PROHIBIT MANIPULATION REGARDLESS OF DIRECTION, AND EVISCERATES THE PROTECTIONS AGAINST MARKET MANIPULATION.

By exculpating manipulative acts that move price in the direction of a court's view of a stock's future "true economic value," the Court of Appeals' decision creates a new "good manipulation" exception to established market manipulation law. This Court's review is called for in light of the serious question raised by this exception—whether manipulative conduct is exempt if it moves the market in an economically desired direction.

A. Actionable Manipulation Is a Major Issue in Current Securities Law.

The subject of actionable market manipulation has generated increasing debate, with some scholars now asserting that manipulation is either not possible or not a problem, and arguing that the entire concept of manipulation liability should be abandoned entirely. *See* D. Fischel and D. Ross, *Should the Law Prohibit "Manipula-*

tion" in Financial Markets?, 105 Harv. L. Rev. 503 (1991). Other scholars insist that manipulation remains a viable concept, and they have stressed the need for continued prohibitions against manipulative tactics. *See* S. Thel, *$850,000 in Six Minutes—The Mechanics of Securities Manipulation*, 79 Cornell L. Rev. 219 (1994).

B. Creating a "Good Manipulation" Exception Within the Seventh Circuit Clashes with Established Law by This Court and Other Circuit Courts Enforcing Liability for Manipulation Regardless of Its Direction.

No prior decision has ever exonerated an otherwise illegal price manipulation on the ground that the activities moved the share price in a specific direction which was the "good" or "right" direction. All previous decisions that address manipulation liability do not consider the direction of the price movement at all. This Court's holdings that market manipulation refers to practices that artificially affect market activity, *Santa Fe Industries, Inc. v. Green*, 430 462, 476-77 (1977), and that a person manipulates the securities markets by conduct willfully controlling or artifically affecting the price of securities, *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976), never consider the direction of the manipulation [11] to be significant, let alone hold that the direction can be dispositive on the liability question.

C. The "Good Manipulation" Exception Conflicts With Other Circuits' Case Law.

The new exception created by the Seventh Circuit conflicts with other circuits, *see Pagel, Inc. v. Securities and Exchange Commission*, 803 F.2d 942 (8th Cir. 1986) (scheme to dramatically increase price despite lack of demand for stock), and *United States v. Charnay*, 537 F.2d 341 (9th Cir.), *cert. denied*, 429 U.S. 1000 (1976) (scheme to depress price in order to deceive company's

[11] I.e., whether the conduct manipulates the price of the security in an economically desirable direction.

shareholders and directors in connection with take-over attempt), which have not found the direction of the price manipulation to be determinative—or even relevant—to the question of liability for manipulation.

D. A "Good Manipulation" Exception Is Untenable, Unworkable, and Abhorrent to the Concept of Free and Open Markets.

All manipulation can be presumed to move price in a direction that benefits the manipulator and harms those investors taking opposite positions, believing that they are investing in a market whose prices are not rigged.

All market participants have a right to expect that prices are not being controlled, and therefore, the new exception announced below confounds the expectations of the investing public. Even if prices are being controlled in a "good", i.e., economically efficient direction, investors will hesitate to enter the market, for as this Court stated in *Basic Inc. v. Levinson*, 485 U.S. 224, 246-47 (1988), "it is hard to imagine that there is ever a buyer or seller who does not rely on market integrity. Who would knowingly roll the dice in a crooked crap game?"

E. The Manipulative Devices at Issue Here Have Been Recognized As Violating § 9(a)(2) of the Securities Exchange Act of 1934, Without Regard to the Direction of the Manipulation.

The decision below also disturbingly erodes the viability of § 9(a)(2) of the Exchange Act, 15 U.S.C. § 78i(a)(2), one of the two sections of the Exchange Act under which the vast majority of manipulation cases are brought, see McLucas and Angiotti, *22 Review of Securities & Commodities Regulation*, No. 10 at 104 (May 24, 1989), and conflicts with the other circuits that have addressed market manipulation under Section 9(a)(2).

Section 9(a)(2) outlaws:

> . . . a series of transactions in any security registered on a national securities exchange creating actual or

> apparent active trading in such security or raising or depressing the price of such security, for the purpose of inducing the purchase or sale of such security by others.

Section 9(a)(2) has been described as the "very heart of the [A]ct." *Crane Co. v. Westinghouse Air Brake Co.*, 419 F.2d 787, 794 (2d Cir. 1989), *cert. denied*, 400 U.S. 822 (1970). Its objective is to ban "device[s] used to persuade the public that activity in a security is the reflection of a genuine demand instead of a mirage." Senate Comm. on Banking & Currency, Stock Exchange Practices, S. Rep. No. 1455, 73d Cong., 2d Sess. 54 (1934). In enacting § 9(a)(2), Congress sought to protect investors, like members of the class here, "by maintaining a market controlled by natural forces rather than by intervention of artificial manipulative devices. . . ." *Trane Co. v. O'Connor Securities*, 561 F. Supp. 301, 305 (S.D.N.Y. 1983).

Scattered's mode of conduct has uniformly been held by the courts to constitute market manpulation under § 9(a)(2) in cases involving schemes analogous to the one here, without respect to the direction of the manipulation. *See Seagoing Uniform Corporation v. Texaco, Inc.*, 705 F. Supp. 918 (S.D.N.Y. 1989) (court upheld plaintiff's § 9(a)(2) claim where complaint alleged defendants' involvement in scheme to drive up price of stock through large purchases and incomplete disclosure, thus enabling defendants to effect quick sale of their stock at premium over artificially inflated market price); *Rooney Pace, Inc. v. Reid*, 605 F. Supp. 158 (S.D.N.Y. 1985) (plaintiff's claim under § 9(a)(2) sustained where plaintiff alleged that defendants effected series of orders to purchase stock while concealing their intention not to pay for stock or to condition payment on increase in price of stock); *United States v. Stein*, 456 F.2d 844, 850 (2d Cir.), *cert. denied*, 408 U.S. 922 (1972) (where activity in stock that public saw was "mirage" rather than reflection of genuine demand, court held: "This was manipulation [under § 9(a)(2)]."); *Crane Co. v. Washinghouse*

Air Brake Co., 419 F.2d 787, 795 (2d Cir. 1969), *cert. denied*, 400 U.S. 822 (1970) ("When a person who has a 'substantial, direct pecuniary interest in the success of a proposed offering takes active steps to effect a rise in the market' in the security, we think that a finding of manipulative purpose is prima facie established.").

F. A "Good Manipulation" Exception Is Difficult, If Not Impossible, to Apply.

The difficulty of application of the new exception is another reason for granting certiorari to review the exception. In considering whether the securities markets can be "rigged" in an appropriate direction, the lower courts will need to determine the "true economic value" of a security at a future given day or period. This would be no small task, as this case demonstrates. In the decision below, the Seventh Circuit declared, without benefit of evidence, a "true economic value" of 3-4¢ for LTV shares during the period from approval of the bankruptcy reorganization plan through the last day of trading, *see Scattered Corp.*, 47 F.3d at 862—even though during the period the share price was much higher, and on the last day of trading, the market set a price of 7.8¢ for an old LTV share.[12] In affirming the dismissal of the case, the Seventh Circuit felt it unnecessary to receive evidentiary submissions on the question of the "true economic value" of the shares—although the market, which is arguably the best judge of economic value, offered a value (price) different from that derived by the Court of Appeals.

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[12] That price probably would have been much higher if Scattered had had to cover the short sales.

II. THE SEVENTH CIRCUIT'S LIMITATION OF ISSUER LIABILITY TO CONVENTIONAL ISSUERS ALSO CREATES A CONFLICT WITH OTHER CIRCUITS OVER WHO MAY BE LIABLE AS AN ISSUER, AND IMPROPERLY RESTRICTS THE SCOPE OF LIABILITY FOR ENGAGING IN UNREGISTERED OFFERINGS OR SELLING UNREGISTERED SECURITIES.

In *Pinter v. Dahl*, 486 U.S. 622 (1988), this Court held that a broker or other person who solicits a purchase of securities could be a "seller" within the meaning of § 12(1).[13] Only this term, in *Gustafson v. Alloyd Co.*, 115 S.Ct. 1061 (1995), the Court ruled that Sec. 12(2) erroneous prospectus liability does not arise from private sales. That leaves open the question whether Sec. 12(1) liability still arises from unconventional public sales. The present case, involving respondent's sale of more than the entire outstanding LTV stock, again calls for granting certiorari to consider § 12(1) question: whether Sec. 12(1) liability extends to a market maker who engages in such a large public short sale volume that it has become an issuer or underwriter, whether for the entire volume, or just the volume in excess of the existing shares.

The gist of petitioners' § 12(1) claim is that Scattered engaged in an unregistered offering and became an issuer: by entering into vast naked short sales, Scattered expanded

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[13] Section 12(1) of the Securities Act, under which plaintiffs and the class seek rescission of their trades, provides that: "Any person who (1) offers or sells a security in violation of section 5 [15 U.S.C. § 77e] . . . shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security." 15 U.S.C. § 77*l*(1). However, section 4(1) provides that the section 5 registration requirements do not apply to "transactions by any person other than an issuer, underwriter, or dealer." 15 U.S.C. § 77d(1).

the amount of LTV stock outstanding but did not comply with the registration provisions of the 1933 Act.[14]

The Court of Appeals declared Scattered free of § 12 (1) issuer liability because it was not the issuing corporation, its controlling person, or a conventional underwriter. While legally "only LTV could issue LTV stock" and "persons controlling LTV, as well as (conventional) underwriters, could also be liable for selling unregistered stock", *Scattered Corp.*, 47 F.3d at 865, the mere fact that Scattered was—in the conventional sense—none of these, does not end the § 12(1) inquiry.

Section 2(4) of the Securities Act defines "issuer" generally as "every person who issues or proposes to issue any security". 15 U.S.C. § 77b(4). Scattered became an "issuer" of LTV stock by exercising complete control over the supply of that security. In contrast to the Seventh Circuit's decision, both the Second and Ninth Circuits have held that any person who participates in a securities distribution can violate the registration requirements of the Securities Act of 1933 *regardless* of the person's lack of official status as an issuer, underwriter or dealer. *See Securities and Exchange Commission v. Chinese Consolidated Benevolent Association, Inc.*, 120 F.2d 738 (2d Cir.), *cert. denied*, 314 U.S. 618 (1941),[15]

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[14] By delivering LTV warrants to cover the naked short sales, without ever disclosing the intention to do so, Scattered also might be viewed as having sold an unregistered hybrid convertible security, in violation of § 12(1).

[15] In *Chinese Consolidated Benevolent Association*, a corporation organized for benevolent purposes which had actively encouraged the purchase of bonds issued by China violated the registration requirements of the 1933 Act, even though the corporation had no official or contractual relationship with the Chinese government, did not purchase and resell bonds to purchasers, nor receive any compensation from any person for these solicitation activities.

and *Securities and Exchange Commission v. Murphy*, 626 F.2d 633 (9th Cir. 1980).[16]

By contrast, the Seventh Circuit's narrow view of the reach of § 12(1) allows those who sell from an artificial and infinite supply of shares, such as Scattered, to escape liability. This frustrates the intention of the Act and its drafters. As adopted, the Section 4(1) exemption from liability (for "transactions by any person other than an issuer . . .") was meant to only exempt routine trading transactions, *Chinese Consolidated Benevolent Association, Inc.*, 120 F.2d 741 (2d Cir. 1941); Securities Act Release Number 5223, Adoption of Rule 144, 1972 Fed. Sec. L. Rep. (CCH) ¶ 78,487 (1972); it was not intended to exempt an enormous solicitation and distribution effort undertaken by investment professionals engaged in a massive short selling scheme.

CONCLUSION

For these various reasons, the petition for certiorari should be granted.

Respectfully submitted,

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[16] In *Murphy*, a corporate president who participated in sale-leaseback transactions with limited partnerships was not exempt from the registration requirements, even though neither the president nor the corporation sold or solicited the sale of any limited partnership interests or served as a general partner. In both cases the mere fact that the defendant was not technically an issuer, underwriter, or dealer, was insufficient, standing alone, to insulate the person from liability for violation of the registration requirements.

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APPENDICES

APPENDIX A

IN THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

No. 94-2015

SULLIVAN & LONG, INCORPORATED, *et al.*,
Plaintiffs-Appellants,

v.

SCATTERED CORPORATION,
Defendant-Appellee.

Appeal from the United States District Court for the
Northern District of Illinois, Eastern Division
Nos. 93 C 4069, 93 C 5346, 93 C 5447, 93 C 5740
Harry D. Leinenweber, *Judge*

ARGUED NOVEMBER 1, 1994—
DECIDED FEBRUARY 8, 1995

Before POSNER, *Chief Judge,* and COFFEY and MANION, *Circuit Judges.*

POSNER, *Chief Judge.* This is an appeal from the dismissal, for failure to state a claim, of a suit that charges violations of the securities laws growing out of a notorious, or at least newsworthy, episode of short selling of

common stock of LTV Corporation. *In re Scattered Corporation Securities Litigation,* 844 F. Supp. 416 (N.D. Ill. 1994); see, e.g., Kurt Eichenwald, "Stock Strategy under Scrutiny," *N.Y. Times,* Aug. 26, 1993, p. D1; Alexandra Peers & Jeffrey Taylor, "Chicago Broker Faces Inquiry over LTV Short Sales," *Wall St. J.,* Aug. 27, 1993, p. C1. The plaintiffs allege a "market manipulation" on an awesome scale that jeopardized the solvency of the Chicago (formerly Midwest) Stock Exchange. But like the district judge we have difficulty understanding what right of the plaintiffs the "manipulation" violated or how they were harmed.

LTV, a large steel producer, entered bankruptcy in 1986. In February of 1993 it announced a proposed plan of reorganization under which existing stock in the company would be replaced by new stock most of which would be issued to the bondholders and other creditors of LTV. Existing stockholders would receive warrants entitling them to purchase some of the new stock. The plan contained an estimate that the new shares would be worth only 3 or 4 cents. When the plan was announced, the old shares were trading for more than 30 cents. There were 122 million old shares outstanding.

The plan was confirmed by the bankruptcy court on May 27, 1993, and the court fixed June 29 as the last day on which the old shares would be tradable. Beginning before the confirmation date, but greatly accelerating on that date, the principal defendant, a Chicago Stock Exchange market maker (a dealer willing both to buy and sell a particular stock or other security for his account on a regular basis, 15 U.S.C. § 78c(a)(38)) with the alarming name of Scattered Corporation, sold short huge quantities of the old LTV shares. It sold short, in fact, tens of millions of such shares a week, for a total, when trading ended on June 29, of 170 million shares, far more than the 122 million old LTV shares outstanding. The excess of shares sold short over total shares outstanding is the focus of the plaintiffs' complaint.

A short sale is a sale at a price fixed now for delivery later. A trader sells stock short when he thinks the price of the stock is going to fall, so that when the time for delivery arrives he can buy it at a lower price and pocket the difference. If, for example, he sells the stock short at 50 cents a share, and the price falls to 40 cents before he delivers the stock, he can buy the stock for 40 cents a share, deliver it to the buyer, and have made a profit of 10 cents. Under the rules of the Chicago Stock Exchange, the buyer in a short-sale situation is entitled to delivery within five working days of the sale. If the seller fails to make delivery (maybe he doesn't have the stock), the rules entitle the buyer to "buy in" the stock, that is, to go out and purchase it on the open market and charge the price to the short seller. See *United States v. Naftalin*, 441 U.S. 768, 771 n.2 (1979). If in our example the price had risen by the end of five working days to 65 cents and the seller did not deliver, the buyer would go into the market, buy the stock at 65 cents, and charge the price back to the short seller. After the completion of the transaction, the buyer would have stock worth 65 cents that he had obtained at a net cost of 50 cents (50¢ + 65¢ — 65¢). Notice that a short seller's potential loss is unlimited, since it is simply the difference between the sale price and the market price—which could be anything.

The plaintiffs in this case were buyers on the other side of Scattered's short sales. They thought the price of the old shares would rise before plunging to 3 or 4 cents by June 29. (An old share would be worth that, rather than, as one might imagine, zero, because the holder of 100 shares was entitled to turn his shares in and receive 1.08 warrants to buy new shares at the rate of one warrant per share. The warrants, being worth approximately 100 times the old shares, were selling for between $3.125 and $4.125.) *Why* they thought this is a puzzle. Since on May 27 it was certain, or virtually so (nothing is *really* certain), that shares of common stock in LTV

would be worth no more than 4 cents in just a month, it is unclear why the stock did not plunge immediately to that level. In fact it remained in the two-digit range for quite some time, and on the very last day of trading was trading at 7.8 cents even though it was within hours of plunging to half that.

Scattered's counsel told us that the only reason the stock did not plunge immediately is that many brokers and investors do not read a plan of reorganization carefully—it is a long, complex, and jargon-ridden document —and hence many of them did not at first, or perhaps even at last, realize that the old stock in LTV would indeed be worth only 3 or 4 cents after the reorganization was completed. The problem may be endemic with reorganizations. Eichenwald's article suggests that many investors misunderstand the significance of news that a company is reorganizing. They see that the price of the stock is "low," and think that they are getting in on the ground floor rather than climbing aboard a sinking ship. See also Kurt Eichenwald "Being Nearly Worthless, Wang Shares, Of Course, Sell Briskly," *N.Y. Times*, Sept. 16, 1993, p. D8. Maybe the stock exchanges or the SEC should do something about these gullibles, since competition, which usually protects the uninformed purchaser, seems not to be working. Scattered, however, disclaims any legal responsibility for educating its buyers, and indeed has none, not being a fiduciary of the people it trades with. *Chiarella v. United States*, 445 U.S. 222, 233 (1980). Its counsel acknowledged that his client hoped to take advantage of these people by selling them stock short. That is what short sellers do: they bet on a declining market, trusting that they have better information or better instincts than other traders, those who will buy from them. There is nothing unlawful about trading on an information advantage, provided that it is not based on inside information, *id.* at 233, 235; *Dirks v. SEC*, 463 U.S. 646, 654-55 (1983); *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 495-96

(7th Cir. 1986), which is not alleged. Scattered merely had a better understanding of the information about the reorganization than the investors with whom it traded. It was not even a matter of its having nonpublic information, though the cases we have just cited make clear that trading on nonpublic information is lawful unless it is inside information. It was a matter of a superior interpretation of public information, the information contained in the plan of reorganization.

The effect of trading on an information advantage is to dispel, by penalizing, ignorance and to bring market values into closer, quicker conformity with economic reality. The profit that such trading brings at the expense of less knowledgeable traders provides the incentive for a private, for-profit firm, such as Scattered, to provide this economic service.

Darwinian this process may appear to be, and yet how many (if any) of the plaintiffs resemble the proverbial widow and orphan, or other harmless prey? Sullivan & Long is the first-listed plaintiff. According to a magazine article that the plaintiffs cited in their complaint, "Mr. Sullivan, who is a member of the CSE's [Chicago Stock Exchange's] board of governors and is an owner of CSE member firm Sullivan & Long Inc., tried to use an arbitration strategy similar to Scattered's to profit from the difference in price between LTV's stock and warrants. But in late June, Mr. Sullivan, who was effectively betting that LTV's stock price would decline, became concerned that the price might rise when he discovered how large a short position Scattered had. He bought LTV shares to cover his own short position, and his firm incurred modest losses. In July, Sullivan & Long filed suit against Scattered . . . ." Peter J.W. Elstrom, "Stock Probe Target Fights Back," *Crain's Chicago Business*, Aug. 30, 1993, pp. 3, 25. The article notes an allegation that Sullivan learned of Scattered's short position in his capacity as a governor of the Chicago Stock Exchange.

Scattered had no intention of delivering any of the LTV stock that it sold short. The last thing in the world that it wanted to do was to acquire and hold a stock that it believed certain to lose most of its value within weeks. Since it had no intention of buying any of the stock, it had no compunctions about selling short more LTV stock than existed. It ran the risk that the people on the other side of the short-sale transactions were right in betting that the price would rise before its terminal plunge, that those people would go into the market and buy stock when the price rose during the five-day period for delivery, and that they would force Scattered to reimburse them for these purchases, as in our hypothetical example of the stock sold short at 50 cents that rises to 65 cents. This risk—the risk that, if the *Crain's* article can be believed, Mr. Sullivan flinched at—did not materialize, because the price maintained its downward course. There were few buy-ins, and Scattered ended up making more than $25 million from its campaign of short selling. The plaintiffs claim that Scattered ignored such buy-in demands as were made upon it, but this is imprecise. Scattered refused to deliver old stock in response to such demands, but did offer warrants on new stock. The amount of old stock that it had sold short represented fewer than 2 million shares of new stock. This was only a small part of the total equity capitalization of the reorganized firm. The vast majority of the new stock was to go to the debtholders of the old firm. It would not have been infeasible for Scattered to buy enough warrants to satisfy all potential buy-in demands with new stock. It would have been infeasible for it to obtain enough old stock to satisfy all such demands in old stock.

We can understand, therefore, Sullivan's flinching. The risk was enormous, precisely because Scattered had sold short more old LTV stock than existed. If all the buyers decided to buy in, and if Scattered were deemed not entitled to pay these buyers with warrants rather than with old stock, the price of the old stock would skyrocket—

unless Scattered sopped up all this demand by continuing to sell short to these buyers. But at some point the buyers would worry about Scattered's ability to make good on all its promises to redeem its short sales. They would demand stock, not further promises to pay a high price if the stock rose in value. When this happened—this balking by the buyers—the plaintiffs would, until Scattered did go broke, be able to make money buying in the stock that Scattered had sold short to them. They say that Scattered prevented the price from rising (and thereby discouraged buy-ins by making them unprofitable) by selling short more and more stock. This is just to say that Scattered, like a bluffer in a poker game, kept redoubling its bet until the other players lost heart. But so what? Scattered's principals may be reckless gamblers, sharpies, wise guys, exploiters of loopholes, even violators of the letter or spirit of the rules of the Chicago Stock Exchange. Cf. *United States v. Naftalin, supra,* 441 U.S. at 776-77. We take no position on these questions, except to note that the Chicago Stock Exchange has forbidden the practice in which Scattered engaged—that is, selling short without having borrowed the stock being sold short or having equivalent guarantees of delivery. But it did this after the short-sale spree that is the basis of this suit, and anyway not every stock exchange rule confers a private right to sue. *Spicer v. Chicago Board of Options Exchange, Inc.,* 977 F.2d 255, 262-66 (7th Cir. 1992).

What troubles us most about this suit is the plaintiffs' failure to identify any harm to the objectives of the securities laws under which they have sued; for that matter they have failed to identify a rule that Scattered violated. The central objective, we take it, is to prevent practices that impair the function of stock markets in enabling people to buy and sell securities at prices that reflect undistorted (though not necessarily accurate) estimates of the underlying economic value of the securities traded. An efficient stock market is one in which stock prices reflect all potentially available information that is relevant

to the economic value of the stocks. Eugene Fama, "Efficient Capital Markets: A Review of Theory and Empirical Work," 25 *J. Finance* 383 (1970). Not every practice that might reduce the efficiency of a stock market is prohibited; the securities laws compose a patchwork of rules rather than a seamless standard. But we would think twice before concluding that these laws prohibit "schemes" that accelerate rather than retard the convergence between the price of a stock and its underlying economic value and therefore promote rather than impair the ultimate goals of public regulation of the securities markets. Objectively, from May 27 on old shares of LTV stock were worth only 3 or 4 cents, and the defendant's campaign of short selling helped move the market price toward that true value. Had the plaintiffs succeeded in *their* scheme of reselling for, say, 50 cents stock that they had bought for 40 cents but that was worth only 4 cents, they would have been contributing to an irrational gyration in stock prices.

The plaintiffs call what Scattered did "market manipulation," a term that refers to tactics by which traders, like monopolists, create artificially high or low prices, prices that do not reflect the underlying conditions of supply and demand. *Ernst & Ernst v. Hochfelder, supra,* 425 U.S. at 199. The only artificial prices, however, were the prices at which LTV stock sold between the confirmation of the plan and the expiration of the old stock. They were artificially high because they so greatly exceeded the stock's true value, which was only 3 to 4 cents. Far from launching a balloon, Scattered's short sales punctured a balloon, bringing prices down to earth where they belonged.

The name for what Scattered did is not market manipulation, but arbitrage. Arbitrageurs are traders who identify and eliminate disparities between price and value, or as in this case between today's price and tomorrow's price where the difference cannot be attributed to any prospective change in value. See *Falco v. Donner Foundation, Inc.,* 208 F.2d 600 (2d Cir. 1953). By doing this, ar-

bitrageurs promote the convergence of market and economic values that we suggested was the central objective of securities regulation. Consider a case in which the identical stock is selling for different prices on two exchanges at the same time. Since the value is the same, the prices should be the same. By buying stock on the exchange where the price is lower and reselling it on the other exchange, the arbitrageur brings about a convergence of price with value. This case is only a little subtler. The old LTV stock and the new stock that was to be issued when the plan of reorganization was implemented were not identical, but they were nearly so. The old stock was the stock until June 29, the new stock the stock thereafter. The two stocks were so far identical (putting aside the irrelevant difference in the roughly 100 to 1 rate at which old shares were convertible into new) that any difference in price between them was more likely to reflect a failure of the stock market to work properly than a difference in underlying conditions of demand and supply. Scattered played the arbitrageur's role in trying to equate the prices of these two nearly identical goods. Arbitrage is not market manipulation. The opposite of a practice that creates artifical prices, it eliminates artificial price differences.

The plaintiffs complain that the defendant prevented them from profiting from their purchases by flooding the market with successive waves of short sales, thus keeping the market price from fluctuating upward from time to time ("capping the price," they call it). Such upturns would have enabled them either to buy in at a higher price than the short-sale price and thus make a profit, if they had bought from Scattered, or to sell at a profit stock that they already owned. But "flooding" a market with short sales is not a rational formula for keeping price falling. On the other side of each such sale is a buyer who thinks the market price will rise. If he is right, the short seller will lose money, and the more shares he has sold short, the more money he will lose. As we have already

intimated, the short seller could sell so many shares short that his solvency was jeopardized. Suppose price rose and everyone who bought the shares sold short by Scattered tried to buy in. Since there would be more stock demanded than there was stock capable of being supplied, the price would soar and Scattered, which we are told was capitalized at only $1.5 million when the short selling began, would, unless it could redeem with warrants, soon go broke. But the plaintiffs are not complaining that if Scattered guessed wrong about the direction of the market, the price of the stock would rise *faster* than if Scattered had sold short fewer shares, for if that had happened the plaintiffs might have made money. And the threat of insolvency is one reason that buyers would have stopped accepting Scattered's offers to sell short, would instead have insisted on delivery or would have bought in and sought reimbursement from Scattered.

The plaintiffs analogize Scattered's plan to the scam in the movie *The Producers*. The "defendants" in that movie sold shares in a play to investors. They sold more than 100 percent of the shares, confident that the play—"Springtime for Hitler"—would be a flop, so that the investors would not ask for their share of the profits (there would be no profits). The play was a success, so the scam was exposed and they were sent to jail. Where the analogy fails is that while investors reasonably believe that the promoter will not sell more shares than exist, since he would then be defrauding the investors, a buyer of stock does not have a basis for equal confidence that the number of shares of a stock that is being sold short does not exceed the total number of shares in existence, since the seller is not trying to raise money for a venture. If even one share of a stock is sold short, there will be more shares actually or potentially for sale than there are shares in existence—since by definition the short seller does not own the share or shares that he is selling short—unless the short seller has borrowed stock in order to be able to

make delivery if the buyer wants delivery. Scattered was not the only short seller of LTV stock. Apparently the first-listed plaintiff in this case also sold LTV stock short. If Scattered had sold only 85 million shares short, and other arbitrageurs had sold in the aggregate another 85 million, the imbalance between shares for sale and shares in existence would have been identical, unless the arbitrageurs borrowed the stock they sold short.

Granted, it is customary for a short seller to borrow the stock that he sells short; if he did not, the buyers would lack confidence that he could deliver, and might worry that if they tried to buy in, the short seller would not have the money to reimburse them. But the plaintiffs do not point us to, and we have not been able on our own to find, a law that *requires* arbitrageurs or other short sellers to borrow the stock that they are selling short. So the plaintiffs could not count on the volume of short sales being capped at the total number of shares outstanding. They were on notice that the sort of thing that did happen might happen, if there were any trader as audacious as Scattered. Being on notice, they were not deceived.

It is true that in 1994—a year after the short selling of LTV's old shares—the Chicago Stock Exchange adopted a rule requiring a short seller to borrow the stock sold short or provide equivalent guarantees of being able to deliver. *Self-Regulatory Organizations: Chicago Stock Exchange, Inc.*, 59 Fed. Reg. 42082 (Aug. 16, 1994). But that is too late to help these plaintiffs. A further complication is that, as we have mentioned, Scattered did have, so far as appears, enough warrants to deliver *new* stock to cover any demands for old stock, though we do not know whether responding to such demands in this way would have satisfied the short-sales rules of the Chicago Stock Exchange or for that matter the contracts of short sale. Since there is not as yet any requirement of public disclosure of short sales (hence the allegation

that Mr. Sullivan abused his position as a governor of the Chicago Stock Exchange), see *Large Trader Reporting System*, 59 Fed. Reg. 7917 (Feb. 17, 1994); *Self-Regulatory Organizations: Notice of Filing of Proposed Rule Change by New York Stock Exchange, Inc.*, 60 Fed. Reg. 518 (Jan. 4, 1995), Scattered itself could not know the precise contribution that its short selling was making to the imbalance of which the plaintiffs complain.

We have thus far assumed that the short seller is not trying to deceive the market about what he is doing. The plaintiffs charge deception. They charge first of all that Scattered did not disclose that it had no intention of delivering any of the stock that it sold short. But if it was selling more shares than were outstanding, it could not deliver them—the requisite number of shares did not exist—so the plaintiffs' real complaint must be that Scattered did not disclose how many shares it was selling. But it was not required to disclose the number and the plaintiffs were not entitled to assume that Scattered would not sell more shares than were outstanding. Beginning on May 27, Scattered bought warrants so that it could deliver new shares to anyone who demanded delivery. The plaintiffs argue and we may assume for purposes of our decision that anyone who demanded delivery before June 29 would have been entitled to old shares. That individual's remedy, when Scattered refused to deliver old shares, would have been to buy them in. Apparently no one bothered to do that. No one who bought from Scattered is complaining that it was not able to buy in old shares, so that the *Brennan* case on which the plaintiffs rely is inapposite. *Brennan v. Midwestern United Life Ins. Co.*, 286 F. Supp. 702 (N.D. Ind. 1968), aff'd, 417 F.2d 147 (7th Cir. 1969). No matter how many tens or for that matter hundreds of millions of shares Scattered sold short, it could not extinguish any of the outstanding shares and thus it could not defeat the right of the buyers, including the plaintiffs in this case, to buy in the old shares and if the price was higher than the

price of the short sales to charge the price to Scattered and pocket the difference. And this is on the assumption that rule or contract required Scattered to deliver old shares, rather than warrants for new shares. If the latter form of compliance with the short-sale contract was permissible, the plaintiffs' case evaporates completely, since Scattered no longer would have been selling short more shares than existed.

The plaintiffs also complain that Scattered falsely marked its trading tickets "short exempt," meaning that Scattered was authorized to sell on down ticks in the market. (This means authorized to sell at a price equal to or below the last sale price, even if *that* price was equal to or below the next preceding sale price.) If Scattered was not exempt, it may have to answer to the Chicago Stock Exchange or the SEC, see SEC Rule 10a-1, but we do not see how its claim of exempt status could have deceived anyone in any respect that bears on this case. Exempt or not, a short sale is a short sale. If anything, the claim of exemption would lead investors to believe that Scattered was going to do *more* short selling than if it were not exempt, since exemption would free it from restrictions on short selling. And the plaintiffs' whole complaint is that they were fooled by the magnitude of the short selling that Scattered did.

Our analysis has shown that nothing alleged in the complaint is the kind of conduct that the securities laws are aimed at combatting. It is therefore not surprising that none of the plaintiffs' specific legal contentions has merit. They contend first and foremost that "by unprecedented massive short selling and by disguising the nature of their trades, the defendants controlled the price of LTV," in violation of section 9(a)(2) of the Securities Exchange Act of 1934. This section forbids "a series of transactions in any security registered on a national securities exchange creating actual or apparent active trading in such security or raising or depressing the price

of such security, for the purpose of inducing the purchase or sale of such security by others." 15 U.S.C. § 78i(a)(2). As the plaintiffs themselves point out, the essence of the offense is creating "a false impression of supply or demand," for example through wash sales, where parties fictitiously trade the same shares back and forth at higher and higher prices to fool the market into thinking that there is a lot of buying interest in the stock. *Santa Fe Industries, Inc. v. Green,* 430 U.S. 462, 476 (1977). There was nothing like that here. On the other side of all of Scattered's transactions were real buyers, betting against Scattered, however foolishly, that the price of LTV stock would rise. And Scattered made no representations, true or false, actual or implicit, concerning the number of shares that it would sell short. Maybe the plaintiffs' theory is that every short seller implicitly warrants that it won't sell short in such quantity as to jeopardize its financial solvency. This is an argument against short selling, or perhaps against short selling without borrowing the shares to be sold short—or perhaps against arbitrage. But other than in tender-offer situations, where short selling is prohibited, SEC Rule 14e-4 (formerly 10b-4; cf. *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Bobker,* 808 F.2d 930, 934 (2d Cir. 1986)), there is as yet no rule barring persons with a pronounced taste for risk from trading on stock exchanges.

Since there was no deception—no *relevant* deception, for as we have said Scattered's claim to be exempt could only magnify the impression that it was selling short far more shares than it could deliver, and thus tend to dispel the deception of which the plaintiffs complain—there is also no basis for a claim under Rule 10b-5, which requires proof of either deception or manipulation. *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.,* 114 S. Ct. 1439, 1448 (1994); *Basic, Inc. v. Levinson,* 485 U.S. 224, 239 n. 17 (1988); *Chiarella v. United States, supra,* 445 U.S. at 232; *Ernst & Ernst v. Hochfelder, supra,* 425 U.S. at 199. Decep-

tion there was not; and most forms of "manipulation" involve deception in one form or another. *Santa Fe Industries, Inc. v. Green, supra,* 430 U.S. at 476-77. We have explained why no nondeceptive practice in which Scattered engaged was manipulative in the sense—the only possible relevant legal sense—of bringing about artificial prices for LTV stock.

As for the claim that Scattered violated section 12(1) of the Securities Act of 1933, 15 U.S.C. § 77*l*, by becoming an issuer of LTV stock without registering the offer or sale as required by that Act, this is quite fantastic. Only LTV could issue LTV stock, although persons controlling LTV, as well as (conventional) underwriters, could also be liable for selling unregistered stock, see 15 U.S.C. §§ 77b(11), 77d(1), 77e, 77*l*(1)—but Scattered was none of these. The remaining claims—violation of RICO, unjust enrichment, and violation of an Illinois consumer protection statute—are either makeweights or depend on contentions that we have already rejected. The complaint fails to state a claim and the suit was therefore properly dismissed.

It was properly dismissed for another reason as well. The plaintiffs could not prove injury with the degree of certainty, low that it is, necessary to obtain an award of damages in a securities case. *Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723 (1975); *Pelletier v. Stuart-James Co.,* 863 F.2d 1550, 1557-58 (11th Cir. 1989). (They do not seek any other form of relief.) They bought stock that was selling for many times its actual value, hoping against hope that there were enough foolish investors to push the price up despite the imminence of its certain plunge. It is entirely speculative that but for Scattered's short selling, the plaintiffs would have sold at a profit or at a reduced loss before the price plunged to its value in the reorganization. The plaintiffs do not suggest that short selling in the stock of a firm undergoing reorganization is forbidden. Other traders might

have seen the opportunity Scattered did, and their short selling might have driven the price sufficiently low to thwart any profit by these plaintiffs. It was not necessary that short selling drive the price all the way down to 7.8 cents (where it was when the music stopped), only that it drive the price below what it would have been had Scattered not sold short in such massive quantities. But to recapitulate the essential point of this opinion, since the conduct in which Scattered engaged appears to have served rather than disserved the fundamental objectives of the securities laws, we are not inclined to strain to find a violation of a specific provision.

AFFIRMED.

A true Copy:

Teste:

Clerk of the United States Court of
Appeals for the Seventh Circuit

APPENDIX B

UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT
Chicago, Illinois 60604

JUDGMENT—WITH ORAL ARGUMENT

Date: February 8, 1995
BEFORE: HONORABLE RICHARD A. POSNER, Chief Judge
HONORABLE JOHN L. COFFEY, Circuit Judge
HONORABLE DANIEL A. MANION, Circuit Judge

No. 94-2015

SULLIVAN & LONG, INCORPORATED,
JOSEPH D. LAPOTA, JR., MARK V. HARKINS, *et al.*,
Plaintiffs-Appellants

v.

SCATTERED CORPORATION,
an Illinois corporation,
Defendant-Appellee

Appeal from the United States District Court for the
Northern District of Illinois, Eastern Division
Nos. 93 C 4069, 93 C 5346, 93 C 5447 and 93 C 5740,
Harry D. Leinenweber, Judge

The judgment of the District Court is AFFIRMED, with costs, in accordance with the decision of this court entered on this date.

APPENDIX C

[Filed Jan. 20, 1994]

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

No. 93 C 4069
No. 93 C 5346
No. 93 C 5447

CONSOLIDATED CASES
JUDGE LEINENWEBER

IN RE: SCATTERED CORPORATION
SECURITIES LITIGATION

MEMORANDUM OPINION AND ORDER

FACTS

Defendant, Scattered Corporation ("Scattered"), is an Illinois corporation engaged in the business of buying and selling securities. During a period between February 26, 1993 and June 29, 1993, Scattered sold approximately 170 million shares of LTV Corporation stock ("old LTV shares" or "old LTV stock"). LTV was one of the nation's largest steel producers, and was embroiled in a long and complicated bankruptcy proceeding. On February 26, 1993, LTV announced a reorganization plan, which would allow the company to emerge from bankruptcy.

Under the plan, current shareholders would be given warrants granting the holder a right to receive "New LTV" stock ("new LTV stock") when, and if, issued. The new LTV stock would replace the old LTV stock, which would cease to exist. Holders of old LTV shares would receive approximately 1.08 warrants for each 100 shares of old LTV stock. This plan was approved by the bankruptcy court on May 27, 1993, and became effective on June 28, 1993. Sale of old LTV stock was halted on June 29, 1993.

Plaintiffs are persons and entities who bought LTV stock from Scattered between February 26, 1993 and June 29, 1993. During this period, plaintiffs allege Scattered sold approximately 170 million shares of LTV stock short. That is, Scattered sold Old LTV shares that it did not own or intend to borrow. Plaintiffs claim that Scattered sold enough stock short to create a false market, driving the price of LTV shares down. They allege that Scattered never intended to deliver the "old LTV" shares they sold. Rather, according to plaintiffs, Scattered intended to cover its sales in one of two ways. First, Scattered could delay issuing the shares until it received "new LTV" shares, which were worth a fraction of the price of "old LTV" shares. Alternatively, Scattered intended never to deliver anything, expecting the shares to be cancelled without further costs to clear.

Plaintiffs' complaint contains four theories of wrongdoing by Scattered. First, plaintiffs' state that Scattered's actions violated section 10(b) and Rule 10(b)(5) of the Securities Act of 1934. Second, Scattered allegedly sold unregistered stock, in violation of section 12(1) of the Securities Act of 1933 ("1933 Act"). Third, plaintiffs maintain that Scattered violated section 1964 of the Racketeer Influenced and Corruption Organization Act ("RICO"), 18 U.S.C. § 1961 et seq. (1993). Fourth, Scattered has allegedly been unjustly enriched by its criminal conduct.

Plaintiffs also seek to impose a constructive trust on defendants', CSX (f/k/a the Midwest Stock Exchange) and MCC, a wholly owned subsidiary of CSX. Plaintiffs claim that these parties currently possess around $5 million of Scattered's profits from the allegedly illegal trading.

Before the court are the following motions: (1) plaintiffs' motion for class certification, (2) Scattered's motion to dismiss, (3) defendants' CSX and MCC's motion to dismiss, (4) defendant motion to strike, (5) plaintiffs' interpleader motion, (6) Scattered's motion to dismiss the interpleader, and (7) plaintiffs' motion for a constructive trust.

The court grants plaintiffs' motion for class certification, reserving the right to create sub-classes in the future if necessary. It also grants defendants' motion to dismiss and gives plaintiffs 7 days to re-plead. In addition, the court finds that the other motions before the court are moot. The court offers the following rationale in support of its decision to grant Scattered's motion to dismiss.

DISCUSSION

I. Standard of Review for Motion to Dismiss

For the purpose of deciding defendant's motion to dismiss, the court assumes the truth of all well-pled factual allegations in the complaint and draws all possible inferences therefrom in favor of plaintiff. *Webster v. New Lenox School Dist. No. 122*, 917 F.2d 1004, 1005 (7th Cir. 1990). Dismissal is not warranted unless it appears beyond doubt that plaintiff could prove no set of facts that would entitle him to relief. *Caldwell v. City of Elwood*, 959 F.2d 670 (7th Cir. 1992).

II. Rule 10(b)(5)

A. Misleading Statements

In order to state a claim under Rule 10b-5, 17 C.F.R. § 240.10b-5,[1] the plaintiff must demonstrate that Scattered: (1) made an untrue statement of material fact or omitted a material fact that rendered the statements made misleading, (2) in connection with a securities transaction, (3) with the intent to mislead, and (4) which caused plaintiff's loss. *Schlifke v. Seafirst Corp.*, 866 F.2d 935 (7th Cir. 1989). The court in *Schlifke* also stated that the express language of Rule 10b-5 proscribes omissions that render affirmative statements misleading; thus, incomplete disclosures, or "half-truths," implicate a duty to disclose whatever additional information is necessary to rectify the misleading statements. *Id.* at 944. Even absent any misleading statements, an independent duty to disclose material facts may be triggered by a fiduciary relationship. *Id.*

In the present case, plaintiffs' well-pled allegations lead the court to the conclusion that it could not recover under Rule 10b-5. First, Scattered's inclusion of the words "short exempt" on their trade tickets did not violate Rule 10b-5. Under Rule 10b-5, to be actionable, a statement must, in fact, be misleading. *Basic, Inc. v. Levinson*, 485 U.S. 224, 239 n.17, 108 S. Ct. 978, 99 L.Ed.2d 194 (1988). Also, there must be a link be-

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[1] It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security. 17 C.F.R. § 240.10b-5.

tween the alleged misrepresentation and either the price received (or paid) by the plaintiff. *Id.* at 248-49.

Plaintiffs have failed to plead facts that would indicate that the statement was, in fact, misleading. Their complaint is devoid of facts that would indicate that the words "short exempt" played any role in their decision to purchase old LTV stock. Additionally, plaintiffs' complaint does not establish the essential link between the alleged misrepresentation and the price they paid for the old LTV stock. Since "short exempt" did not mislead plaintiffs, Scattered had no duty to disclose additional information concerning its trading activities. Nothing in the consolidated complaint would support a conclusion that the words "short exempt" affected the market for old LTV shares during the class period. Thus, the words could not have affected the price plaintiffs paid for the old LTV shares.

Furthermore, plaintiffs have failed to state facts that would establish the existence of a fiduciary relationship between plaintiffs and Scattered. Scattered, therefore, had no independent duty to disclose material facts to plaintiffs under Rule 10b-5.

B. Market Manipulation

Section 10(b) proscribes the use of "any manipulative or deceptive device or contrivance in contravention of the rules and regulations [of the SEC] employed in the purchase or sale of designated securities." Rule 10b-5, promulgated under this provision, details certain prohibited deceptive practices.

For Rule 10b-5 purposes, " 'manipulation' . . . refers generally to practices . . . that are intended to mislead investors by artificially affecting market activity." *Santa Fe Indus., Inc. v. Green,* 430 U.S. 462, 476 (1977). Injection of accurate information into the market price does constitute market manipulation. *In re Olympia Brewing Co. Securities Litigation,* 613 F. Supp. 1286,

1292 (N.D.Ill. 1985). According to the court in *In re Olympia,* short selling "is simply not unlawful, even in large numbers and even if the trading does negatively affect the price." *Id.* Also, "[w]here the trading volume and price simply reflect supply and demand based on accurate market information, this is lawful market behavior, not market manipulation." *Id.*

Sometime in February of 1993, the United States Bankruptcy Court for the Southern District of New York issued "The LTV Second Modified Joint Plan of Reorganization and Disclosure Statement Pursuant to Section 1125 of the Bankruptcy Code." The Plan and Disclosure Statement provided: "The estimated value of the consideration to be received by the holders of the Old LTV common stock would be approximately 3.22 cents." With this information, an efficient market would have driven the price of old LTV stock down during the period leading up to June 29, 1993, the date on which old LTV shares stopped trading.

Plaintiffs in the present case recognize that Scattered's short selling of stock, alone, was not unlawful. Plaintiffs also agree that the effect of Scattered's trading on the market was perfectly consistent with efficient market activity. That is, plaintiffs maintain that Scattered's short sales injected accurate information into the market, which drove the price of old LTV stock down. Thus, in light of plaintiffs factual allegations, and the reasonable implications therefrom, the court finds that plaintiffs would not be entitled to relief based on a theory that Scattered's activity artificially affected the market.

III. Sale of Unregistered Stock

Plaintiffs maintain that Scattered sold around 50 million more shares of old LTV than existed. In addition, plaintiffs claim that Scattered, according to its scheme, distributed LTV warrants in place of the old LTV shares it sold. Both of these acts, plaintiffs allege, constitute

the sale of unregistered stock in violation of section 12 (1) of the 1933 Act. 15 U.S.C. § 771(1) (1993). Plaintiffs further allege they are entitled to recover the consideration paid for the security with interest or damages under 15 U.S.C. § 771(2).

According to the 1933 Act, 15 U.S.C. § 77e:

> Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or (2) to carry or cause to be carried through the mails or interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

However, section 77d of the 1933 Act states: "The provisions of § 77e of this title shall not apply to . . . transactions by any person other than an issuer, underwriter, or dealer." 15 U.S.C. § 77d(1) (1993).

With regards to the old LTV shares sold by defendants, the court finds that plaintiffs have proven no set of facts that would entitle them to relief. Specifically, plaintiffs have failed to provide the court with facts that would establish that Scattered was an "underwriter" of the old LTV shares. Therefore, pursuant to 15 U.S.C. § 77d, Scattered was not bound by the registration requirments of section 77e. Further, in light of the court's finding, the primary authority plaintiff's cite in support of their theory is distinguishable from the present circumstances. The defendant in *S.E.C. v. Graystone Nash, Inc.*, 820 F. Supp. 863 (D.N.J. 1993), was an underwriter of the stock in question and, therefore, subject to the registration requirements in section 77e.

The court also finds that plaintiffs cannot prove facts which would entitle them to relief based on their claim

that Scattered's sale of LTV warrants violated section 77e. The facts alleged by plaintiffs in their consolidated complaint maintain that, "Scattered defendants offered to and sold all 122 million . . . shares of *old LTV* common stock. . . ." Plaintiffs' Consolidated Complaint, ¶ 70; *see also* Plaintiffs Response to Defendant's Motion to Dismiss, at p.23 ("Scattered did not sell LTV warrants"). Plaintiffs allege, and Scattered agrees, that it sold *old LTV* shares, not LTV warrants. While the court notes that Scattered would have been in an extremely precarious situation if the LTV warrants were never issued, it cannot find that it sold unregistered LTV warrants when plaintiffs admit that Scattered sold old LTV shares. Furthermore, plaintiffs do not refute the fact that the LTV warrants, when issued on June 28, 1993, were exempt from registration under section 1145 of the Bankruptcy Code.

IV. RICO Claims

In Count IV of their consolidated complaint, plaintiffs claim that Scattered's short-selling scheme constitutes securities fraud and is a "racketeering activity" under 18 U.S.C. § 1961(1) (1993). Scattered's activity, according to plaintiffs, violated 18 U.S.C. § 1962(c), which provides:

> It shall be unlawful for any person employed by or associated with any enterprise engaged in, or the activities of which affect, interstate or foreign commerce, to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs through a pattern of racketeering activity or collection of unlawful debt.

However, the court has found that plaintiffs can prove no set of facts that would establish that Scattered's short-selling activity violated federal securities laws. Scattered's activities, therefore, do not constitute "racketeering activity" under 18 U.S.C. §§ 1961(1) or 1962(c). Plaintiffs have alleged no additional facts that would entitle them to relief under RICO.

V. Unjust Enrichment

To state a cause of action based on a theory of unjust enrichment, a plaintiff must allege that the defendant has unjustly retained a benefit to the plaintiff's detriment, and that defendant's retention of the benefit violates the fundamental principles of justice, equity, and good conscience. *HI Health Care v. Mt. Vernon Hosp.*, 131 Ill.2d 145, 137 Ill.Dec. 19, 26, 545 N.E.2d 672 (1989).

After a review of the well-plead factual allegations in the complaint, and drawing all possible inferences therefrom in favor of plaintiffs, the court finds that plaintiffs have not stated a claim that would entitle them to recover for unjust enrichment. More specifically, Scattered's retention of benefits would not violate the principles of justice, equity or good conscience. The well-plead facts indicate that Scattered took advantage of the information it possessed—information that was available to the public. Scattered took the risk that the LTV warrants would, in fact, be issued in the future. It exploited an inefficient market which did not accurately reflect the value of old LTV stock. Further, plaintiffs fail to state facts that would indicate that they would not have lost money if Scattered had issued the old LTV shares. In fact, plaintiffs do not even allege that they demanded their old LTV shares from Scattered during the class period.

VI. Constructive Trust

In order to impose a constructive trust under Illinois law, a court must find, "some form of wrongful or unconscionable conduct." *Chas. Hester Ent. v. Ill. Founders Ins. Co.*, 114 Ill.2d 278, 293 (1986). In the present case, the court finds that plaintiffs can prove no set of facts which would establish that Scattered engaged in wrongful or unconscionable conduct. Instead, the facts asserted by plaintiffs indicate that Scattered took advantage of the information it possessed and exploited the market's inability to accurately reflect the price of old

LTV stock. As a result of the court's finding, plaintiffs are not entitled to impose a constructive trust on Scattered's funds, which are held by defendants CSX and MCC.

VII. CONCLUSION

The court grants Scattered's motion to dismiss and gives plaintiffs 7 days to amend its complaint. The court points out that it is unclear from the facts pled when and how Scattered produced LTV warrants to cover the 170 million shares of old LTV stock it sold. Also, plaintiffs failed to provide sufficient facts to establish that Scattered unjustly benefitted to the detriment of plaintiffs in this case. Plaintiffs maintain that Scattered intended to produce something in return for the old LTV shares it sold: either old LTV shares or LTV warrants. In either scenario, Scattered's buying activity would have raised the price of the old LTV stock or warrants. The court is simply unpersuaded that plaintiffs have stated a claim absent evidence that plaintiffs requested, were denied, and would have sold their old LTV shares.

IT IS SO ORDERED.

/s/ Harry D. Leinenweber
HARRY D. LEINENWEBER
Judge
United States District Judge

DATED: 1/20/94

APPENDIX D

TRANSCRIPT OF DISTRICT COURT'S ORAL RULING

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93 C 4069

IN RE SCATTERED CORP. SECURITIES LITIGATION

ORAL RULING—March 29, 1994

This cause of action arises out of defendant Scattered Corporation's short-selling of stock in LTV Corporation. Plaintiffs are a class of persons who purchased LTV shares from defendant. In a previous ruling dated January 20, 1993, this court dismissed plaintiffs' complaint. Subsequently, plaintiff's filed an Amended Consolidated Complaint, which contains seven theories of wrongdoing by defendant: (1) Securities fraud under Rule 10b-5; (2) market manipulation; (3) sale of unregistered securities; (4) unjust enrichment; (5) violations of RICO; (6) violations of the Illinois Securities Act; and (7) violation of the Illinois Consumer Fraud and Deceptive Practices Act. Defendant moves to dismiss.

For the purpose of deciding defendant's motion to dismiss, the court assumes the truth of all well-pled factual allegations in the complaint and draws all possible inferences therefrom in favor of plaintiff. *Webster v. New Lenox School Dist. No. 122*, 917 F.2d 1004, 1005 (7th Cir. 1990). Dismissal is not warranted unless it appears beyond doubt that plaintiff could prove no set of facts that would entitle him to relief. *Caldwell v. City of Elwood*, 959 F.2d 670 (7th Cir. 1992).

In its amended complaint, plaintiffs again claim that defendant made misleading statements that constituted violations of Rule 10b-5. Plaintiffs offer two theories establishing a Rule 10b-5 violation. First, they allege that defendants never intended to produce the "Old LTV" shares they purported to sell. Second, plaintiffs maintain that they were misled by the "short exempt" language on the OLD LTV shares defendant sold.

The Seventh Circuit has stated that in the context of Rule 10b-5, it is insufficient for plaintiffs to allege the cause of their entering into a transaction in which they lost money, but not the cause of the transaction's turning out to be a losing one. *Bastian v. Petren Resources, Inc.*, 892 F.2d 680, 683-84 (7th Cir. 1990). Also, as this court previously stated, a Rule 10b-5 violation requires a link between the alleged misrepresentation and either the price received or paid by the plaintiff. *Basic, Inc. v. Levinson*, 485 U.S. 224, 239 n.17 (1988).

In the present case, the court finds that plaintiff has failed to allege the cause of the demise of Old LTV stock. Consistent with its prior ruling, the court further concludes that plaintiffs have failed to establish the essential link between the alleged misrepresentation and the price they paid for the Old LTV stock. First, plaintiffs' do not allege that they would have sold the Old LTV shares had defendant delivered them. In addition, the court dismisses plaintiffs contention that defendant's use of "short exempt" was the "but for" cause of their purchase of the stock. Plaintiffs admit that defendants short selling caused the price of Old LTV shares to decline. The court agrees with defendant that with or without defendant's actions, the price of Old LTV stock would have declined.

Thus, the facts in this case indicate that the but for cause for plaintiffs' losses on LTV shares was a bankruptcy reorganization plan, which drove the price of stock down. The plan would have had this result regard-

less of action by defendant. Thus, the court grants defendant's motion to dismiss plaintiffs' Rule 10b-5 claim since they have failed to plead sufficiently the causation element of the rule. The plaintiffs significantly do not allege that they were unaware of the impending bankruptcy reorganization or that defendant did anything to prevent them from learning about it.

The court also finds that plaintiffs' factual claims do not establish a claim for market manipulation under Rule 10(b) of the Securities Act of 1933 or Section 9(a)(2) of the Securities and Exchange Act of 1934. Both of these statutes require plaintiffs to plead facts establishing that defendant injected artificial or inaccurate information into the market. As this court has previously stated, however, defendant's trading did not artificially affect the market for Old LTV shares by injecting false information into the market. Nor did defendant's alleged violation of certain trading rules constitute a manipulation of the market. Instead, defendant's trading had precisely the same effect that an efficient market would have; defendant, by selling, caused the price of Old LTV stock to decline.

In their amended complaint, plaintiffs maintain that defendant issued an unregistered hybrid security in violation of Section 12(1) of the Securities Exchange Act of 1933, 15 U.S.C. § 771(2). The court disagrees. In addition, plaintiffs again have failed to plead facts establishing that defendant was an issuer, underwriter, or dealer under 15 U.S.C. § 77d(1). Therefore, as it did previously, the court finds that plaintiffs have failed to plead facts which would entitle them to relief under Section 12(1).

The factual basis for plaintiffs' unjust enrichment claim in their amended complaint is identical to that in the original complaint. It therefore fails on the same grounds. Plaintiffs still do not claim that they demanded their

Old LTV stock certificates. Further, the court has found that the effect of defendant's trading activity was no different than what could be expected in an efficiently operating market. Under these circumstances, the court finds that defendant's conduct did not violate fundamental principles of justice, equity, or good conscience.

In their response brief, plaintiffs urge the court to consider their wire fraud allegations as a basis for their RICO claim. The court has weighed the charges, but for the reasons stated in its previous ruling the court finds that plaintiffs have failed to plead a violation of RICO.

The court also finds that plaintiffs' claims under the Illinois Securities Act, 815 ILCS 5/12 (1993), must succumb to defendant's motion to dismiss for two reasons. First, the court has found that defendant did not violate Rule 10b-5. Second, the court has determined that defendant did not issue a hybrid security.

Finally, this court has found that the Illinois Consumer Fraud and Deceptive Business Practices Act applies to federally and state regulated securities transactions. *Horizon Federal Savings Bank v. Selden Fox & Assoc.*, 1988 WL 70473 (N.D. Ill. June 30, 1988). The court now agrees with its brother court that compliance with federal and state regulations is a defense to liability under the Act. *Wislow v. Wong*, 713 F. Supp. 1103, 1107 (N.D.Ill. 1989). Since plaintiffs have failed to plead a violation of federal or state regulations, the court dismisses its claim under the Illinois Consumer Fraud and Deceptive Business Practices Act.

In sum, the court now dismisses with prejudice plaintiffs' Amended Consolidated Class Complaint and Plaintiffs' Consolidated Class Complaint insofar as plaintiffs have attempted to incorporate it by reference. Defendant's Renewed Motion to Dismiss is granted.

APPENDIX E

UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT
Chicago, Illinois 60604

March 13, 1995

Before Hon. RICHARD A. POSNER, Chief Judge
HON. JOHN L. COFFEY, Circuit Judge
HON. DANIEL A. MANION, Circuit Judge

No. 94-2015

SULLIVAN & LONG, INCORPORATED, *et al.*,
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SCATTERED CORPORATION,
Defendant-Appellee.

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Harry D. Leinenweber, *Judge*

ORDER

On February 22, 1995, plaintiffs-appellants filed a petition for rehearing with suggestion for rehearing en banc. All of the judges on the original panel have voted to deny the petition, and none of the active judges * has requested a vote on the suggestion for rehearing en banc. The petition is therefore DENIED.

*** Hon. Ilana Diamond Rovner did not participate in the consideration of the rehearing en banc.**